

1 **BELLSOUTH TELECOMMUNICATIONS INC.**
2 **BEFORE THE**
3 **PUBLIC SERVICE COMMISSION OF SOUTH CAROLINA**
4 **DOCKET NO. 2003-326-C**
5 **SURREBUTTAL TESTIMONY OF**
6 **DR. RANDALL S. BILLINGSLEY, CFA**
7 **MARCH 31, 2004**
8

9 **I. INTRODUCTION**
10

11 **Q. Please state your name, occupation, and business address.**

12 A. My name is Randall S. Billingsley. I am a finance professor at Virginia Polytechnic
13 Institute and State University. I also act as a financial consultant in the areas of cost of
14 capital analysis, financial security analysis, and valuation. My business address is:
15 Department of Finance, Pamplin College of Business, Virginia Polytechnic Institute and
16 State University, Blacksburg, Virginia 24061-0221.

17
18 This surrebuttal testimony presents my independent professional opinions and is not
19 presented by me as a representative of Virginia Polytechnic Institute and State
20 University.
21
22
23

1 **Q. Have you previously submitted testimony in this proceeding on behalf of BellSouth**
2 **Telecommunications Corporation (BST)?**

3 A. Yes.
4

5 **II. PURPOSE OF SURREBUTTAL TESTIMONY AND SUMMARY OF**
6 **CONCLUSIONS**

7 **A. PURPOSE OF SURREBUTTAL TESTIMONY**
8

9 **Q. What is the purpose of your testimony in this proceeding?**

10 A. My purpose is to critically evaluate the cost of capital-related portions of the rebuttal
11 testimonies of two other witnesses in this proceeding. First, I evaluate Mr. Don J. Wood's
12 rebuttal testimony filed on behalf of AT&T Communications of the Southern States, L.L.C.
13 (AT&T), which is dated March 12, 2004. I show that his rebuttal testimony provides no
14 insight into the current capital costs faced by competing local exchange companies
15 (CLECs) in general or any specific insight into the appropriate discount rate to be used in
16 the BellSouth Analysis of CLEC Entry (BACE) model. Second, I evaluate Dr. Robert
17 Loube's rebuttal testimony filed on behalf of Staff of the Public Service Commission of
18 South Carolina, which is dated March 12, 2004. I explain that his attempted revision of my
19 recommended cost of capital for use in the BACE model is incorrect and unsupported by
20 any empirical evidence or independent analysis. Below I summarize my analysis of Mr.
21 Wood's rebuttal testimony. Given the limited scope of Dr. Loube's comments on the cost
22 of capital, I present my analysis of his testimony in section IV below after my analysis of
23 Mr. Wood's testimony.

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2 **B. SUMMARY OF SURREBUTTAL OF MR. DON J. WOOD’S**

3 **REBUTTAL TESTIMONY ON BEHALF OF AT&T**

4 **COMMUNICATIONS OF THE SOUTHERN STATES, L.L.C.**

5

6 **Q. What issues does your surrebuttal focus on in Mr. Wood’s rebuttal testimony**
7 **concerning the CLEC industry’s capital costs?**

8 A. My surrebuttal shows that most of Mr. Wood’s testimony provides nothing more than
9 unsupported speculations concerning CLEC capital costs and the rest presents inconsistent
10 and incorrect arguments that leave us with no evidence on current CLEC capital costs.
11 Importantly, Mr. Wood provides *absolutely no estimates* of CLEC capital costs. I identify
12 numerous examples of his unsupported personal opinions in my surrebuttal. Further, I
13 focus on Mr. Wood’s inconsistent and incorrect argument that currently operating CLECs
14 possess inefficient, sub-optimal capital structures and yet at the same time somehow are
15 economically efficient. This contradictory argument dramatizes his misunderstanding of
16 the information provided by currently operating, market-traded CLECs concerning their
17 capital costs. I also evaluate Mr. Wood’s misguided projection that past CLEC
18 infrastructure investments and associated bankruptcies will necessarily be repeated in the
19 future. In summary, Mr. Wood’s unsupported and incorrect observations tell us nothing
20 meaningful about the appropriate discount rate that should be used in the BACE model.

1 **III. ANALYSIS OF MR. DON J. WOOD'S REBUTTAL TESTIMONY ON**
2 **BEHALF OF AT&T**

3 **A. QUALIFICATIONS AS A COST OF CAPITAL EXPERT**
4

5 **Q. Are you familiar with Mr. Wood's testimony as a cost of capital expert in other**
6 **regulatory proceedings?**

7 A. No. While I have read and rebutted Mr. Wood's testimony in other regulatory proceedings,
8 in my experience he has always simply summarized the cost of capital recommendations
9 made by the cost of capital expert(s) working in the given case. I am not familiar with any
10 independent work done by Mr. Wood as a cost of capital expert. I am consequently
11 surprised that he appears to consider himself a cost of capital expert in the current
12 proceeding and I know of no basis for doing so.
13

14 **B. EVIDENCE CONTRADICTING MR. WOOD'S ASSUMPTION OF**
15 **CLEC INEFFICIENCY**
16

17 **Q. Do you agree with Mr. Wood's position that CLECs are currently operating**
18 **efficiently?**

19 A. No, I believe that the evidence contradicts Mr. Wood's position. He incorrectly argues
20 that:

21 ... the fact that a significant number of CLECs have gone bankrupt suggests
22 that competitive market constraints have winnowed the field and those CLECs
23 that currently are operating do have efficient operations. In order to make

1 reasonable assumptions about efficient CLEC costs, it is logical to look at
2 currently operating CLECs (Rebuttal Testimony, p. 50, lines 5 - 10).

3
4 Mr. Wood's argument reduces to unsupported speculation that CLECs that did not go
5 bankrupt are, by definition, necessarily operating efficiently. As shown in my direct
6 testimony in this proceeding, the average bond rating for a sample of market-traded CLECs
7 is CCC+/CCC (see Billingsley Exhibit No. RSB-6). This is a speculative-grade bond rating
8 that is associated with firms in financial distress. Consider the following definition of the
9 CCC-level rating:

10 An obligation rated 'CCC' is currently vulnerable to nonpayment, and is
11 dependent upon favorable business, financial, and economic conditions for the
12 obligor to meet its financial commitment on the obligation. In the event of
13 adverse business, financial, or economic conditions, the obligor is not likely to
14 have the capacity to meet its financial commitment on the obligation (*Standard*
15 *& Poor's Bond Guide*, October 2003, p. 4).

16 It is absolutely amazing that Mr. Wood argues that such firms should be used "... to make
17 reasonable assumptions about efficient CLEC costs." The evidence obviously contradicts
18 this. Further, Mr. Wood's reliance on unadjusted data drawn from inefficient CLECs is
19 inconsistent with the Federal Communication Commission's (FCC's) assertion that the cost
20 of capital should reflect a forward-looking, efficient network (see Triennial Review Order,
21 In Re Review of the Section 251, Unbundling Obligations of Incumbent Local Exchange
22 Carriers, First Report and Order on Remand and Further Notice of Proposed Rulemaking,
23 FCC 03-36, released August, 21, 2003, pp. 419-420, §682).

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2 **C. INCONSISTENT ARGUMENT THAT CLEC CAPITAL STRUCTURES**

3 **ARE NOT EFFICIENT**

4

5 **Q. After arguing that CLECs are currently operating efficiently, does Mr. Wood also**

6 **argue that current CLEC capital structures are not efficient, target capital**

7 **structures?**

8 **A.** Yes. Mr. Wood states:

9 This structure is clearly not the target capital structure of these companies, but

10 has arisen in large part because of the precipitous drop in the companies' stock

11 prices (Rebuttal Testimony, p. 57, lines 18 - 20).

12 Mr. Wood is inconsistent. On one hand he argues that CLECs are efficient and a reasonable

13 source of representative capital costs. Yet on the other hand he argues that their current

14 capital structure is not equal to their target, optimal capital structure. His only explanation

15 for this contradictory speculation concerning current CLEC capital structures is that they

16 are the result of the "precipitous drop in the companies' stock prices." Mr. Wood's

17 contradictory, inconsistent argument does not make sense. The truth that must be faced is

18 that CLECs are not currently efficient in a comprehensive sense. It is consequently

19 reasonable to use the averaging process that I do to produce a representative bounded

20 estimate of representative CLEC capital costs. It is eminently appropriate to bound current

21 CLEC costs on the downside with the S&P 500 and on the upside with capital costs

22 produced by a CLEC sample, which is obviously in an inefficient condition.

23

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2 **D. MR. WOOD’S SPECULATIONS CONCERNING CLEC FUTURE**
3 **INFRASTRUCTURE INVESTMENTS**
4

5 **Q. What speculation does Mr. Wood make concerning future CLEC infrastructure**
6 **investments based on history?**

7 A. The gist of Mr. Wood’s speculation is that CLECs have no capacity to understand or to
8 avoid their past mistakes. He states that:

9 ... CLECs invested in network infrastructure (large fixed costs) based on an
10 anticipation of future revenues that would make their market entry economic.
11 Their assumptions regarding whether entry in this manner would be economic,
12 now clearly flawed, are very similar to the assumptions that BellSouth is now
13 inviting CLECs to make through the results of its business case analysis (and is
14 asking the Commission to conclude that the CLEC’s should accept the
15 invitation). ... CLECs face a decision of whether or not to invest in network
16 infrastructure (in this case a local circuit switch, whose cost characteristics
17 cause it to represent a large fixed cost). BellSouth argues that they could
18 rationally do so ... (Rebuttal Testimony, p. 54, line 27 - p. 55, line 10).

19 Thus, Mr. Wood attributes the CLECs past woes to network infrastructure investments with
20 “large fixed costs” and predicts that CLECs will necessarily experience the same troubles
21 again in the future. However, I do not share Mr. Wood’s uncomplimentary view of the
22 CLECs’ ability to learn from past challenges. The future is not necessarily a simple
23 extension of the past and learning is possible.

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2 **E. RELATIVE RISK OF CLECS AND ILECS**

3

4 **Q. Does Mr. Wood provide any evidence to support his position that CLECs face higher**
5 **risks than incumbent local exchange companies (ILEC's)?**

6 A. No. Mr. Wood offers no evidence on the relative riskiness of CLECs and ILECs. He only
7 expresses his unsupported opinion as follows:

8 There is a fundamental difference in the risk incurred by a former monopoly
9 provider, with existing network facilities and an existing base of customers, and
10 the risk incurred by a new entrant to enter the market by making a large fixed
11 investment without the customer base needed to recover the cost of that
12 investment (Rebuttal Testimony, p. 53, lines 1 - 5).

13 He then speculates that "... a CLEC continues to face, for the reasons described above,
14 much higher risk than an ILEC" (Rebuttal Testimony, p. 54, lines 9 - 11).

15

16 While CLECs may well be riskier than ILECs, any possible difference should be
17 *demonstrated* using empirical evidence rather than *assumed*. Mr. Wood *speculates* about
18 the relative risks of ILECs and CLECs when evidence is needed, not his opinion.

19

20 **IV. ANALYSIS OF DR. LOUBE'S REBUTTAL TESTIMONY ON**
21 **BEHALF OF STAFF OF THE PUBLIC SERVICE COMMISSION OF**
22 **SOUTH CAROLINA**

23

1
2 **Q. What is your assessment of Dr. Loube’s revision of your estimated cost of capital**
3 **for use in the BACE model?**

4 A. Dr. Loube rejects my estimation approach without providing any basis for doing so.
5 Further, he incorrectly revises my analysis, in part, by doubling the amount of equity
6 in the representative CLEC’s capital structure “[b]y making a conservative
7 adjustment to the CLEC average equity percentage, increasing the percentage from
8 12.47 percent to 25.0 percent ...” (Rebuttal Testimony, p. 39, lines 12 – 14).
9 However, he provides no empirical justification for this revision nor any independent
10 cost of capital estimates. Consequently, Dr. Loube only attempts to substitute his
11 unsupported opinion for the results of my empirically-supported cost of capital
12 estimate for use in the BACE model. Dr. Loube’s rebuttal testimony provides no
13 useful evidence concerning CLEC capital costs.

14
15 **V. SUMMARY OF COST OF CAPITAL ANALYSIS FOR BACE MODEL**
16

17 **Q. Please summarize your recommendation concerning the appropriate pre-tax overall**
18 **cost of capital that should be used to calculate the NPV in the BACE model.**

19 A. As presented in my previously filed direct testimony in this proceeding, my cost of capital
20 estimation approach adapts to the data problems resulting from the current troubled
21 environment facing the CLEC industry. I essentially provide “ceiling” and “floor”
22 estimates of the industry’s capital costs. Thus, I use two surrogates to measure the
23 representative CLEC’s capital costs. I use the S&P 500 as a lower-bound or minimum

1 estimate of the representative CLEC's cost of capital and I also use a sample of publicly-
2 traded CLECs that provides an upper-bound or maximum estimate of the representative
3 CLEC's cost of capital. I then provide a reasonable estimate of the industry's overall
4 capital costs by averaging the results of my two approaches.

5
6 My analysis indicates that a forward-looking cost of equity estimate for the representative
7 CLEC is an average of 17.55%. I also find evidence that the cost of debt of the
8 representative CLEC is an average of 9.92%. The average market value-based capital
9 structure of firms is 58.50% debt and 41.50% equity. Combining this average capital
10 structure with the above average costs of debt and equity produces an average pre-tax
11 overall cost of capital for the representative CLEC of 13.09%. This bounded averaging
12 approach provides the most reasonable estimate of efficient CLEC capital costs in the
13 current environment.

14
15 In summary, I recommend that the Public Service Commission of South Carolina use a
16 *before-tax* overall cost of capital of 13.09% as an input in the BACE business case model.
17 This cost of capital should be adjusted to reflect the effect of taxes before using it to
18 discount the after-tax cash flows generated by the BACE model.

19
20 **Q. Does this conclude your surrebuttal testimony?**

21 A. Yes, it does.